No. 20,845

United States Court of Appeals

For the Ninth Circuit

KENT-REESE ENTERPRISES, INC., RAYMOND DOUGLASS and ROBERT REESE,

Appellants,

vs.

WALTER HEMPY, Trustee of Big Boy Markets, Inc., Bankrupt,

Appellee.

APPELLANTS' CLOSING BRIEF

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PERNAU-WALSH PRINTING CO., SAN FRANCISCO

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APPELLANTS' CLOSING BRIEF

The essence of Appellants' appeal is the belief that the trial court *erred in finding* that the Nov. 1, 1959 agreement (Exhibit 15) *did not effect an immediately-effective "transfer"* of the security and offset rights set forth in the instrument.

FACTS SUPPORTING APPELLANTS' APPEAL.

The relevant facts supporting the case of Appellants and compelling the conclusion that the security rights granted to Kent-Reese Enterprises, Inc. (herein called "Kent-Reese") constituted an immediately-effective "transfer" under the Act are the following:

(a) The three-way agreement was *made on Nov. 1, 1959* when Big Boy Markets, Inc. (herein called "Big Boy Markets"), was solvent and in full operation of its several super markets. (Tr. p. 2, line 25 through p. 3, line 11).

(b) *As of Nov. 1, 1959* the individual Appellants relinquished their right to the immediate cash repayment of their $30,700 (Tr. p. 8a, line 4, Item 6 of the Findings through p. 9, Item 8) for the purpose of benefitting Big Boy Markets, then solvent, helping that corporation's operating capital position by accepting the guarantee of Kent-Reese rather than demanding their cash (Tr. p. 9, lines 30-32, Item 8 of Findings).

(c) *As of Nov. 1, 1959* Appellant Kent-Reese incurred an immediately effective contractual obligation to the individual Appellants by its *unconditional guarantee* (Tr. p. 9, lines 8-10 and 30-32). It then agreed:

> ". . . KENT-REESE ENTERPRISES, INC., hereby guarantees to RAYMOND DOUGLASS and/or JOAN DOUGLASS and/or ROBERT REESE the payment in full by BIG BOY MARKETS, INC., of the sums set forth above" (i.e., said $30,700.)

(d) *As of Nov. 1, 1959* the then-solvent Big Boy Markets, in consideration of said unconditional guarantee, unconditionally agreed:

> ". . . to hold KENT-REESE ENTERPRISES, INC., free and harmless from any loss or liability under the above agreement and as security

therefor does hereby grant to KENT-REESE ENTERPRISES, INC., the right to a credit upon its PROMISSORY NOTE obligation. . . ."

and made the other express and immediately-effective contractual arrangements set forth in said instrument (Tr. p. 9, lines 11-16).

(e) Big Boy Markets continued in business for eleven months nineteen days after this agreement until Oct. 19, 1960 when Big Boy Markets filed its petition in bankruptcy and was adjudicated a bankrupt (Tr. p. 8, lines 2-6).

(f) Appellant Kent-Reese, after the bankruptcy of Big Boy Markets, met its guarantee obligations to the individual Appellants by payment of the sums guaranteed and it offset this amount against the balance of $31,000 then remaining unpaid on its $54,000 promissory note obligation to Big Boy Markets (Tr. p. 10, line 19 through p. 11, line 1, Items 11 and 12 of Findings).

Because the trial court decided that the actions and facts did not result in a transfer effective as of Nov. 1, 1959, the court applied the ruinous (to Appellants) legal fiction and implication that "such transfer is deemed by law to have been made immediately before the filing of the petition in bankruptcy" (Tr. p. 11, lines 31 and 32). From this fictional, implied time of transfer followed the conclusions of law numbered 3, 4, 6 and 9 (Tr. pp. 12 and 13) which result in the technical conclusions of law and judgment that Appellants were guilty of a transfer as of Oct. 19, 1960

which made them guilty of a fraud and subject to the trial court's inescapable and damning judgment.

The injustice resulting from this error of the trial court in applying the law to the facts is obvious:

(1) The individual Appellants who relinquish their rights to the return of $30,700 on Nov. 1, 1959 acting in good faith and for the benefit of Big Boy Markets, and

(2) Appellant Kent-Reese, the corporation which made it possible for the Bankrupt to retain the use of this $30,700 as part of its operating funds in reliance upon the security granted to it by Big Boy Markets (i.e., through the right of offset against money owing by it to the Bankrupt)

are by the trial court's decision stigmatized as having worked a fraud upon the corporation they helped.

The injustice is, further, that although the combined arrangement and concessions of the Appellants resulted in Big Boy Markets enjoying and having the benefits of Appellants' $30,700 as additional cash operating funds from Nov. 1, 1959 forward, by the error of the trial court's decision the Appellants and particularly Kent-Reese would be denied the security upon which they relied before acting to their detriment to accommodate and benefit Big Boy Markets.

We call the appellate court's attention to the fact that these sums supplied by the individual Appellant and guaranteed and paid to them by Kent-Reese are all "hard dollars". There has been no claim by Appellants of any interest or any other compensation

for the Bankrupt's use of said $30,700 from 1958 and 1959 (Tr. p. 8a, lines 4-11 and p. 10, lines 24-32; Items 6 and 12 of Findings).

There should possibly be some greater differentiation between the different legal situations or positions of the Appellants:

(A) Individual Appellants Douglass and Reese received nothing directly from the Bankrupt. They proceeded to seek the recovery of their $30,700 upon the unconditional guarantee by Kent-Reese by their claim for payment against Kent-Reese. They received their money only from Kent-Reese on the basis of that guarantee—*they received nothing from the Bankrupt* (Tr. p. 10, lines 24-32).

(B) Kent-Reese prior to the bankruptcy reduced its $54,000 promissory note balance payable to Big Boy Markets until it equaled the approximate balance which it had guaranteed to the individual Appellants, Douglass and Reese (Tr. p. 10, lines 14-23). At the time of bankruptcy, *Kent-Reese then refused to pay the remaining loan balance (which constituted its security for its unconditional guarantee)* basing its right of offset upon the Nov. 1, 1959 contract which it claims was fully effective and operative as of that date (Tr. p. 10, line 24 through p. 11, line 5 and Appellants' Opening Brief).

OPPOSITION ARGUMENTS OF REPLY BRIEF.

In the Reply Brief the rebuttal of our authorities, ideas and arguments rest only upon the narrow issue and contention (see p. 6 of Reply Brief) that the trial court's decision was correct to the effect that the Nov. 1, 1959 transaction did not then effect a present transfer of security rights under the definitions sections 30 and 60a(2) of the Act *because*:

(a) The Nov. 1, 1959 security agreement "was never perfected as required by State law", and

(b) Unless the transfer was ". . . so perfected against such liens . . .", that is, against liens or rights of other creditors of bona fide purchasers, then ". . . it shall be deemed to have been made immediately before the filing of the petition."

We shall address this Closing Brief, therefore, to refuting of Appellee's citations and arguments made in his efforts to support these contentions.

GUARANTY AND SECURITY-OFFSET AGREEMENT AND RIGHTS THEREUNDER WERE PERFECTED WHEN EXECUTED ON NOV. 1, 1959.

Replying to Appellee's contentions (pp. 4 through 13 of Reply Brief) by reference to those same letters and subjects, Appellants respectfully present their closing arguments, etc., as follows.

(A) Transfer Was Perfected When Contract Was Executed.

The *Aulick v. Largent* (1961) 295 Fed. 2d 41 case cited by Appellee relates to a situation involving a transfer actually contracted for and made within four

months of filing of the bankruptcy petition and made at a time when the bankrupt was actually already insolvent.

This case is therefore irrelevant to the case at bar where Big Boy Markets was in the full swing of operating its supermarkets and was solvent when it made the Nov. 1, 1959 agreement which is under examination here, that is, where it made the security-offset agreement eleven months and nineteen days prior to the bankruptcy petition filed Oct. 19, 1960.

Appellee cites *In re Quaker City Sheet Metal Co.* (1942) 129 Fed. 2d 894 and *In re Kaufmann* (1956) 142 Fed. Sup. 759 as authority for the proposition that the security rights of Appellants were not perfected because other parties could have acquired rights superior to those of Kent-Reese as against its rights of offset under the Nov. 1, 1959 contract.

Neither of these cases appears to be in point.

There appears to be no question but that *the guaranty which Kent-Reese made to the individual Appellants* Douglass and Reese was *absolute, unconditional and fully effective on Nov. 1, 1959. That is not an issue* in this case but illustrates the immediate effectiveness which the parties intended for the agreement.

We are, therefore, analyzing *only the question as to whether or not the security-offset aspects of the Nov. 1, 1959 agreement created, as between Kent-Reese and Big Boy Markets, an immediate lien and offset and security* rights in favor of Kent-Reese which became fixed, enforceable and perfected rights as of that date.

In the *Quaker City Sheet Metal* case the creditors whose secured-claim status was being questioned were creditors who had made loans to the Bankrupt *within four months prior to filing of bankruptcy* and who, *within* that four-months critical time took an assignment of contracts and of accounts receivable arising from those contracts as collateral security for these loans. *But they did not give notice* of those assignments to the persons owing the accounts receivable so assigned as required by state law.

In this case the appellate court reversed the trial court (which had found the assignment to the bank to be entitled to preference as a secured creditor) and found, instead, that because these creditors had not given notices of the assignment to the debtors of the accounts assigned they had not perfected the assignments under Pennsylvania law. The majority decision in this case (there was a strong dissenting opinion) at page 896 shows that this decision rested upon (a) the fact that the assignments were executed within four months of bankruptcy and (b) the fact that no notices of the assignments were given. This case is therefore irrelevant as authority for the case at bar. In statements revealing the reasoning of the court, the majority opinion stated:

> "There remains for consideration the question whether under the law of Pennsylvania subsequent bona fide assignees or attaching creditors of the company could have acquired rights to the accounts receivable here in question superior to the rights of the bank and Dearden under their prior assignments in view of the fact that the

latter gave no notice of their assignments to the persons owing the accounts.

"The trustee urges that under the law of Pennsylvania a subsequent bona fide purchaser of the accounts receivable from the company could have acquired rights to the accounts superior to those of the bank and Dearden provided only that he gave notice before they did. In support of this proposition the case of In re Phillips' Estate (No. 3), 1903, 205 Pa. 515, 55 A. 213, 66 L.R.A. 760, 97 Am.St.Rep. 746, is cited. That case involved a contest between successive assignees of a fund in the hands of a third person. The court found in favor of the subsequent assignee, adopting the rule that (205 Pa. at page 524, 55 A. at page 216) 'if an assignee fails to give notice to the person holding the fund assigned to him, a subsequent assignee, without notice of the former assignment, will, upon giving notice of his assignment, acquire priority'."

The *Kaufmann* case in Kentucky involved an unrecorded conditional sales contract where the security to the (preferred) creditor was perfected under Kentucky law only five days prior to the adjudication in bankruptcy.

In relevant parts of this decision the federal court said (at page 760) on the relevant issues which distinguish this case from the case at bar:

"However, in 1950 Congress amended Section 60 of the Bankruptcy Act and it now provides that the recognition of equitable liens would be denied where available means of perfecting a legal lien have not been employed. Section 60, sub.a(6) of

> the Bankruptcy Act, 11 U.S.C.A., § 96, sub.a(6), Republic National Bank of Dallas v. Vial, 5 Cir., 1956, 232 F. 2d 785.
>
> "[1-4] In Kentucky a conditional sales contract must be recorded to be perfected as against subsequent lien creditors, KRS 382.270."

Under California law there are no requirements of recordation relative to the transfers of promissory notes whether they be non-negotiable or negotiable. None of Appellee's cited cases related to promissory notes. They related to accounts receivable and conditional sales contracts in states having special laws relative to the prerequisites of perfecting such transfers.

In the case at bar there were both notice and possession in the pledgee of the promissory note insofar as the officers of both corporations which were signatories to the promissory note and, later, to the security-offset agreement were the same persons and both of these corporations had the same president (Appellant Douglass was president and a director of both corporations) and Appellant Reese was an officer (secretary-treasurer of Big Boy Markets and vice president of Kent-Reese and a director of both corporations) and between them said officers owned seventy-five (75%) percent of the stock of both corporations and participated in these transactions (Tr. p. 8, lines 11-24; Items 3 and 4 of Findings).

Appellee next cites *Walters v. Bank of America* (1937) 9 Cal. 2d 46, 69 Pac. 2d 839 for the proposition that the offset rights of Kent-Reese could not be

invoked to defeat a garnishment and *quoting an incomplete portion* of the case report misleadingly.

The facts of this case were that a garnishment was levied against a bank account of the debtor. The debtor owed money to defendant Bank of America and the bank, therefore, had a right of offset. Had it exercised that right of offset, no lawsuit would have been justified. Instead, however, *defendant bank did not offset* the funds in its control against the debtor's obligations to the bank after notice of garnishment but allowed the debtor to have the full benefit of its deposited money to satisfy drafts and obligations to other persons.

The alleged quotation "cited" or "quoted" by Appellee at page 7 of Appellee's Reply Brief nowhere appears on that page and the omission on the second line of the "quotation" printed in Appellee's Reply Brief entirely changes the sense. On page 57 of this California Supreme Court Report the actual and exact quotations of the first two paragraphs are as follows, the second being the exact quotation nearest that printed in Appellee's Reply Brief and indicating by asterisks the omission therefrom which changes the meaning of the portion "quoted" in said Reply Brief:

> "The case of Prudential Loan & Trust Co. v. Metzler, supra, likewise involved the right of set-off of a garnishee bank of a debt due from its depositor. We find the following stated: 'The bank had the right to apply the funds in its hands at the time of the garnishment, belonging to Metzler, to the payment of a debt due from the latter to it . . . But it had no right to pay such funds to

> the order of Metzler during the garnishment proceedings and such payment was at the risk of the Bank . . . As between the attaching creditor and the judgment debtor the garnishee should occupy a disinterested position, and hold the money or property garnished until the matter is adjudicated or the attachment is discharged. (Citing authorities.) The bank waived the privilege of applying the funds upon Metzler's notes by paying him the same during the pendency of the garnishment proceedings. By so doing it clearly indicated that there was no intention on its part to do so. . . .'
>
> "To allow the garnishee to claim his right of setoff to defeat the claim of the creditor, * * * and then to permit him to pay the fund in controversy to the defendant * * *, would result in an unwarranted interference with the rights of other creditors of the defendant. (Trottier v. Foley, supra.)"

At page 56 of this case the California Supreme Court cited with approval the Illinois Appellate Court case of *Obergfell v. Booth,* 218 Ill. App. 492 and said:

> "The court stated: 'While the garnishee, under the provisions of the statute, has the right, upon being notified of garnishment proceedings, to adjust any demands it may have against the judgment debtor, it cannot enter into any new agreements with the debtor involving money or property which it holds to secure the debt, which agreements may operate to the detriment of the attaching creditor . . . Inasmuch as the garnishee chose to enter into this new arrangement with the judgment debtor, after it had been served with

process in this case and had filed its answer as above set forth and had thus postponed its use or right to use the collateral [deposit] in bringing about the payment of the indebtedness, and continued to hold such collateral, we are of the opinion that the trial court did not err in entering judgment against the garnishee for the amount of the deposit.' In other words, inasmuch as the amount of the deposit was not actually applied in payment of the debt, but was continued to be held by the bank as the property and for the benefit of the debtor, it must be considered to have been held likewise for the benefit of the attaching creditor."

This case also is then inapplicable to the case at bar because in that case the bank had not offset the security lien which it had against the funds it owed to the garnisheed debtor but had released the funds to or for the benefit of the debtor, waiving its security lien and right of offset. *In the case at bar, however, Appellant Kent-Reese did offset* against the money which it owed to Big Boy Markets in exact compliance with the provisions of the Nov. 1, 1959 contract granting it the security of the right of offset, etc.

This right of offset as a legally enforceable and proper right was later referred to with approval in the case of *Hauger v. Gates* (1954) 42 Cal. 2d 752, 269 Pac. 2d 609 in a general discussion of that subject citing the *Walters* case.

Next Appellee cites *Hecht v. Smith* (1960) 183 Cal. App. 2d 723, 7 Cal. Rptr. 209, on a case having to do

with a negotiable promissory note. This case does not support Appellee's contention, primarily because the case at bar does not concern a negotiable promissory note but, rather, a non-negotiable promissory note.

The trial court did not find the subject promissory note to be a negotiable instrument. Counsel for Appellants will endeavor to augment the record by a copy of the promissory note of May 1, 1959 (Exhibit 11) and a copy of Appellants' "CLOSING POST-TRIAL MEMORANDUM", which deals at length specifically with this question.

In the *Hecht* case the question before the court was whether or not to dissolve an attachment which was levied against a negotiable promissory note owned by defendant which was in the possession of a third party (which promissory note happened to be a promissory note by the plaintiffs to defendant, which did not alter the situation or decision). There was no claim by the defendant or the third party holding the negotiable promissory note as to any rights of offset or security. This case also therefore fails to be relevant to the issue in the case at bar.

(B) Date of Surety Agreement Controls Effective Date of Transfer.

Under this part of the Reply Brief, Appellee cites *Davis v. Woolf* (1945) 147 Fed. 2d 629. However, this is a case which turned upon the fact that the corporation involved was found to have been insolvent at the time of the transfer.

The law is not disputed by Appellants that such a transfer would be a preference in fraud of creditors if made at a time when the corporation was insolvent and within four months of the date of filing in bankruptcy; however, *that was not the situation in the case at bar.*

Appellants' Opening Brief sets forth the applicable law requiring a corrected finding that the security-offset contract of Nov. 1, 1959 between Kent-Reese and Big Boy Markets was effective as of its date of execution as a "transfer" under the Act, a "transfer" effective, operative and fully enforceable as of that date.

(C) The Nov. 1, 1959 Transfer Was Not Voidable Under California Law.

Appellee cites and relies upon the provisions of California Civil Code § 3440 to claim that the contractual creation of a right of offset and the creation of the security to Kent-Reese by contract on Nov. 1, 1959, were in violation of this statute.

Section 3440 is one of the major sections under the Uniform Fraudulent Conveyance Act. This act could conceivably cover this situation if it were not for the express exception not cited by Appellee in its quotation from Section 3440. Section 3439.01 defines a "conveyance" under this act as including such an assignment, pledge, creation of a lien or encumbrance on tangible or intangible property, but provides, in its parts essential for this analysis:

> "Every transfer of personal property and every lien on personal property made by a person hav-

> ing at the time the possession or control of the property, and not accompanied by an immediate delivery followed by an actual and continued change of possession . . . is conclusively presumed fraudulent and void as against the transferer's creditors . . . as against purchasers or encumbrancers in good faith subsequent to the transfer".

As the very first exception the following paragraph reads:

> "This section shall not apply to any of the following: (a) Things in action . . ."

First: Appellee's case and findings are devoid of any proof or finding that any of the creditors represented by the Appellee were "purchasers or encumbrancers in good faith subsequent to the transfer."

Second: The exception of "things in action" exempts from the operation of this "fraudulent conveyances" statute such things as promissory notes and similar choses in action (a synonym for "things in action"). This act is intended principally to cover commercial transactions relating to tangible goods and merchandise and for this reason "things in action" are specifically exempted from its provisions.

California Civil Code § 953 defines a "thing in action" and states: "a thing in action is a right to recover money or other personal property by a judicial procedure."

In the case of *Marroquin v. Barrial* (1959) 174 Cal. App. 2d 540, 345 Pac. 2d 30 it *was held that a transfer*

of a promissory note and of the deed of trust securing the same *even where the debtor retained both the promissory note and the trust deed* (without recording an assignment of the note and/or trust deed) *was not a fraudulent transfer* as against a creditor seeking to garnishee the same.

California cases have found "things in action" to include the following classes of property similar to promissory notes:

(a) An open, current and mutual account. See *Pedley v. Doyle* (1918) 177 Cal. 284, 170 Pac. 602;

(b) A contract of guaranty. See *Reios v. Mardis* (1912) 18 Cal. App. 276, 122 Pac. 1091;

(c) Bank savings pass book. See *In re Douglas Estate* (1961) 197 Cal. App. 2d 258; 17 Cal. Rptr. 89;

(d) (Appellee's discussion relative to mortgages.)

Appellants make no contention that this Nov. 1, 1959 security-offset contract created any mortgage and no discussion of this subject appears to be necessary therefore.

CONCLUSION

If the analysis of the facts and law as set forth in Appellants' Opening Brief is correct, as we believe it to be, and if the decision of the trial court on the critical issue of the effective date of the "transfer" is in error as we believe the facts and the law discussed in this Closing Brief further affirmatively prove (without relying for this conclusion upon the deficiencies of the irrelevant citations of the Reply Brief) we respectfully submit that the decision of the trial court must be reversed to make the decision accord with the facts of the case and the applicable California and Bankruptcy Act laws and to prevent a grievous injustice in both stigmatizing the Appellants with the unmerited charge of commercial fraud and the ruinous burden of a monetary judgment unmerited by their conduct in endeavoring to assist Big Boy Markets at a time when it was solvent and when the assistance of the Appellants benefitted it and gave it increased cash operating funds at the expense of valuable consideration and concession by both of them.

Dated, Oakland, California,
January 12, 1967.

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